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No. 90-379

In the Supreme Court of the United States

OCTOBER TERM, 1990

PAUL FISHER, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

KENNETH W. STARR
Solicitor General

SHIRLEY D. PETERSON
Assistant Attorney General

CHARLES E. BROOKHART
JOEL A. RABINOVITZ
Attorneys
Department of Justice
Washington, D.C. 20530
(202) 514-2217

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QUESTION PRESENTED

Whether the Commissioner, in a civil tax case employing the net worth method for determining income, may prove fraud by evidence other than a consistent pattern of understating substantial amounts of income.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A33-A47) is unreported, but the decision is noted at 904 F.2d 703 (Table). The opinion and decision of the Tax Court (Pet. App. A1-A32) are reported at 57 T.C.M. (P-H) ¶ 88,151.

JURISDICTION

The judgment of the court of appeals was entered on May 22, 1990. A petition for rehearing was denied on June 14, 1990. Pet. App. A48. The petition for a writ of certiorari was filed on August 27, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Petitioners, who are husband and wife, filed joint federal income tax returns for 1976 and 1977 reporting adjusted gross incomes of $12,261 and $11,925, respectively. Following an audit, the Commissioner employed the net worth method to determine petitioners' income for those years and issued notices of deficiency asserting civil penalties for fraud.[1] Pet. App. A34. The Tax Court sustained the Commissioner's determinations, and the court of appeals affirmed.

1. Petitioner, who holds a degree in business administration from the University of Texas, was an inveterate gambler. He gambled on golf, poker and football, as well as at casinos in Las Vegas. Petitioner joined several golf clubs after concluding that his income from gambling at those clubs would exceed the cost of membership. Most of petitioner's wagers were made in cash, and he kept no record of his winnings or losses. Pet. App. A34.

Petitioner placed bets with a bookie named Bobby Joe Chapman. Petitioner and Chapman did not settle up after each wager. Instead, they kept a running total of winnings and losses. From time to time, one would call the other to request payment. Petitioner paid Chapman by purchasing cashier's checks made out to fictitious persons and sending them to Chapman. Chapman held these checks for a time. If petitioner won subsequent wagers, Chapman returned the checks; if not, he sent the checks to third parties to be cashed. Because bookmaking is illegal in Texas, Chapman destroyed his records as

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[1] The addition to tax for fraud under 26 U.S.C. 6653(b) was asserted only against Paul Fisher. Consequently, the references to "petitioner" in this brief are to Mr. Fisher.

soon as the accounts were settled. Petitioner kept no record of the bets he made with Chapman. Pet. App. A4-A5, A35.

Despite his extensive gambling activities, petitioner reported no gambling income on his 1976 tax return. On his 1977 return, he reported $15,000 of gambling winnings as "other income." Pet. App. A35.

The Commissioner began an investigation of petitioner in 1978. During several interviews with Revenue Agent Paul Rocha, petitioner gave contradictory answers to questions about his finances. Pet. App. A35, A46. For example, petitioner stated that he had received no loans during the years in question, and also that he had received substantial loans from his father. *Id.* at A40-A41. Because petitioners had failed to keep adequate financial records, the Commissioner employed the net worth method to reconstruct their income.[2] The Commissioner determined that petitioners had understated their gross income by $113,791 in 1976 and $104,703 in 1977. *Id.* at A35.

Petitioner was indicted in March 1983 on two counts of willfully attempting to evade and defeat income taxes for 1976 and 1977, and two counts of willfully making false returns for 1976 and 1977. In addition, the Commissioner issued notices of de-

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[2] In applying the net worth method, the Commissioner establishes the taxpayer's net worth at the beginning of the period in question, and then calculates the taxpayer's change in net worth during the period. The taxpayer's income is the sum of his non-deductible expenditures and the change in his net worth. If this sum exceeds the taxable income reported to the government, the difference represents unreported taxable income. See *Holland* v. *United States*, 348 U.S. 121, 125 (1954).

ficiency to petitioners for the 1976 and 1977 tax years that asserted civil penalties for fraud. Pursuant to a plea bargain, petitioner pleaded guilty to willfully making a false return for 1976 and the government dismissed the other criminal charges. Pet. App. A35. Petitioners filed a petition in the Tax Court contesting the Commissioner's determinations and the civil fraud penalties for both years.

2. The Tax Court upheld the determinations and civil penalties. Pet. App. A1-A31. The court concluded that the Commissioner had proved by clear and convincing evidence that there was an underpayment of tax for each year. The court considered and rejected petitioners' various objections to the Commissioner's net worth analysis. *Id.* at A18-A27. In addition, the court held that the Commissioner had proved by clear and convincing evidence that at least part of the underpayment was due to fraud. The court noted that the existence of fraud is determined by examining the entire record. Here, the court found several indicia of fraud, including petitioner's failure to keep records of his gambling activities, his use of cash and cashier's checks payable to fictitious persons, his false and misleading statements to IRS agents, and his plea of guilty to willfully filing a false return for 1976. Because the Commissioner had proved fraud, the court held that the three-year statute of limitations of 26 U.S.C. 6501(a) did not bar the collection of back taxes and penalties. Pet. App. A27-A29.

3. The court of appeals affirmed. Pet. App. A33-A47. The court rejected petitioners' argument that the Tax Court had incorrectly shifted the burden of proof, noting that once the Commissioner meets his burden of proving fraud by clear and convincing evidence, the burden shifts to the taxpayer to prove the

Commissioner's income determinations incorrect. *Id.* at A36-A37. The court also rejected petitioners' objections to the Commissioner's net worth computations. *Id.* at A37-A44. The court considered petitioners' contention that cashier's checks in the amount of $35,700 for 1976 and $48,450 for 1977 represented deductible gambling losses rather than non-deductible living expenses. Even if the cashier's checks are assumed to represent deductible gambling losses, the court observed, the Commissioner proved understatements of $42,310 for 1976 and $7,860 for 1977. Moreover, petitioners failed to present any records, receipts, or witnesses (other than petitioner) to support the contention that the checks represented deductible gambling losses. *Id.* at A44-A45.

The court of appeals upheld the Tax Court's finding of fraudulent intent, noting that several indicia of fraud were present. Petitioner's income was from illegal activities, he failed to keep adequate records despite his knowledge of business practices, he made his transactions difficult to trace by dealing in cash and cashier's checks payable to fictitious third parties, and he made false and inconsistent statements to the IRS agents investigating his activities. Pet. App. A46. In a footnote to its opinion, the court of appeals rejected petitioners' argument that "in order to prove fraud the Commissioner must prove a 'consistent pattern of underreporting substantial amounts of income.' " *Id.* at A46 n.9. The court said that such a pattern is "merely one of the indicia of fraud on which the Commissioner may rely." *Ibid.*

ARGUMENT

Petitioners contend (Pet. 3-6) that the Commissioner, in order to prove fraud in a net worth case, must show a consistent pattern of underreporting substantial amounts of income. In this case, the Commissioner proved that petitioners substantially underreported their income for two consecutive years. And in any event, as the court of appeals correctly observed (Pet. App. A46 n.9), the Commissioner need not show a pattern of underreporting to prove fraud. This Court has recognized that fraud may be shown by "*any* conduct, the likely effect of which would be to mislead or conceal." *Spies* v. *United States*, 317 U.S. 492, 499 (1943) (emphasis added). Accordingly, there is no basis for further review.

1. In order to prove fraud in a net worth case, the Commissioner must show that a not insubstantial amount of income was unreported, and that at least part of the underreporting was due to fraud. See, *e.g.*, *United States* v. *Holovachka*, 314 F.2d 345, 357 (7th Cir.), cert. denied, 374 U.S. 809 (1963). The requirement that the amount of the understatement be not insubstantial allows for the inherent imprecision of the net worth method of proof. See generally *Holland* v. *United States*, 348 U.S. 121, 125-129 (1954). Here, both courts below considered petitioners' objections to the Commissioner's net worth calculations and concluded that the Commissioner had proved, by clear and convincing evidence, a substantial amount of unreported income for both 1976 and 1977. There is no reason for this Court to revisit those fact-bound determinations.[3]

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[3] Petitioner's contention (Pet. 5) that $7,860 of unreported income in 1977 is not "substantial" is untenable. Petitioners

Once the Commissioner demonstrates a not insubstantial understatement of income, he may prove fraud by surveying the taxpayer's entire course of conduct and drawing reasonable inferences from that conduct. See *Korecky* v. *Commissioner*, 781 F.2d 1566, 1568 (11th Cir. 1986). To be sure, a consistent pattern of underreporting substantial amounts of income is convincing evidence of fraudulent intent. See, *e.g.*, *Schwarzkopf* v. *Commissioner*, 246 F.2d 731, 734 (3d Cir. 1957); *Gatling* v. *Commissioner*, 286 F.2d 139, 145 (4th Cir. 1961). But that hardly leads to the conclusion that it is impossible to prove fraud in the absence of such a pattern. Other factors, such as the use of cash or cashier's checks that are difficult to trace, *United States* v. *Holovachka*, 314 F.2d at 358; *Feichtmeir* v. *United States*, 389 F.2d 498, 503-504 (9th Cir. 1968); failure to keep business records despite the knowledge that one should do so, *United States* v. *Allen*, 522 F.2d 1229, 1235 (6th Cir. 1975), cert. denied, 423 U.S. 1072 (1976); *Korecky* v. *Commissioner*, 781 F.2d at 1568; and making inconsistent, false, or misleading statements to IRS agents, *United States* v. *Slutsky*, 487 F.2d 832, 844 (2d Cir. 1973), cert. denied, 416 U.S. 937 (1974) (bank deposit case); *Feichtmeir* v. *United States*, 389 F.2d at 503-504—all of which were present here—also are persuasive indicia of fraud.

Petitioners correctly cite *Holland* v. *United States*, *supra*, for the proposition that fraud may be found from "a consistent pattern of underreporting large amounts of income." 348 U.S. at 139. But nothing in

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reported income of only $11,925 for 1977; by omitting at least $7,860, petitioners understated their actual income by at least 40%.

Holland suggests that such a pattern is a prerequisite to a finding of fraud in a net worth case. On the contrary, *Holland* cited as support for the quoted statement the statement in *Spies* v. *United States* that fraud may be inferred from "any conduct, the likely effect of which would be to mislead or conceal." 348 U.S. at 139 (citing 317 U.S. at 499-500). In addition, *Holland* stated that "[w]hen there are no books and records, willfulness may be inferred * * * from that fact coupled with proof of an understatement of income." 348 U.S. at 128.

Finally, petitioners assert (Pet. 5) that fraud cannot be proved by the net worth method where there is evidence of only one year's understatement of income. As noted above (note 3, *supra*), this contention does not fit the facts of this case, because the Commissioner that proved petitioners substantially understated their income for both 1976 and 1977. In any event, petitioners' contention is incorrect. The Commissioner is not required to wait until a taxpayer has fraudulently underreported his income for several years to assess a fraud penalty. None of the cases cited by petitioners supports such a bizarre rule.[4]

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[4] In *Watts* v. *United States*, 212 F.2d 275 (10th Cir. 1954), only a single tax year was at issue. None of the other cases cited by petitioners (Pet. 4) holds that a multi-year pattern of underreporting is necessary to prove fraud in a net worth case. See *United States* v. *Eley*, 314 F.2d 127, 132 (7th Cir. 1963) (willfulness may be inferred from conduct); *United States* v. *Skalicky*, 615 F.2d 1117, 1120 (5th Cir. 1980), cert. denied, 449 U.S. 832 (1980) (pattern of underreporting, coupled with other evidence, permits an inference of willfulness); *Schwarzkopf* v. *Commissioner*, 246 F.2d 731, 734 (3d Cir. 1957) (consistent pattern, standing alone, is sufficient evidence of fraudulent intent); *Gatling* v. *Commissioner*, 286 F.2d 139, 145 (4th Cir. 1961) (pattern of underreporting may

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

KENNETH W. STARR
Solicitor General

SHIRLEY D. PETERSON
Assistant Attorney General

CHARLES E. BROOKHART
JOEL A. RABINOVITZ
Attorneys

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be convincing evidence of fraud; pattern is more convincing when supported by other indicia of fraud); *Epstein* v. *United States*, 246 F.2d 563, 566 (6th Cir. 1957) (consistent pattern is evidence of willful intent), cert. denied, 355 U.S. 868 (1957); *Shaw* v. *Commissioner*, 252 F.2d 681, 683 (6th Cir. 1958) (consistent pattern is persuasive evidence of fraud); *United States* v. *Larson*, 612 F.2d 1301, 1305 (8th Cir. 1980), cert. denied, 446 U.S. 936 (1980) (consistent pattern may be used to establish inference of willfulness). In *United States* v. *Burdick*, 221 F.2d 932 (3d Cir. 1955), cert. denied, 350 U.S. 831 (1955), the court sustained the conviction without resort to the net worth method of proof. 221 F.2d at 933.

(2) U. S. GOVERNMENT PRINTING OFFICE: 1990 282061 20166